



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 19, 2001

MEMORANDUM FOR COMMISSIONER ROSSOTTI

A handwritten signature in cursive script, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Office of Audit's Comments Concerning Management's
Response to the Audit Report, "*Initial Electronic Filing of Large
Partnership Returns Was Successful, but Additional Checks Are
Needed to Ensure the Accuracy of Information From These
Returns Used in Matching Programs*" (Reference Number
2001-30-167)

This memorandum presents our concerns with the Internal Revenue Service's (IRS) management response to the subject audit report. The response to the report was received after the final report was released.

Management took adequate corrective action for two issues we identified during the course of the audit. However, management's response to the report recommendation was not adequate. Management stated that they would not perform up-front Taxpayer Identification Number (TIN) validation and other recommended accuracy and validation checks for electronically filed U.S. Returns of Partnership Income (Form 1065) and associated schedules; Partners' Share of Income, Credits, Deductions, etc. (Schedule K); and Partner's Share of Income, Credits, Deductions, etc. (Schedule K-1). The recommendation, management's response, and the Office of Audit's concerns follow.

Recommendation: The Electronic Tax Administration (ETA), along with the Compliance function of the Small Business/Self-Employed Division and the Pre-Filing and Technical Guidance function of the Large and Mid-Size Business Division, should develop controls to ensure the accuracy of Forms 1065 and Schedules K-1 and improve the success of the matching programs. Primary consideration should be validity checks for TINs on Forms 1065 and Schedules K-1 and checks to ensure tax data from Forms 1065 are in agreement with the sum of corresponding figures reported on the individual Schedules K-1.

Regarding this recommendation, we also noted in our report that there are certain returns, specifically Publicly Traded Partnerships, for which the Form 1065 may not be

in agreement with the Schedules K-1. This is because brokerage firms use nominee accounts for reporting purposes, which can result in over-reporting. However, these Publicly Traded Partnerships are easily identified and provisions could be made to program exception criteria for these returns.

Management's Response:

1. The IRS will not implement up-front checks of the partnership (Form 1065) TIN before accepting electronically filed Forms 1065. As the Form 1065 e-file program continues to mature, the IRS may adjust specific validations and tolerances.
2. The IRS will not validate the Schedule K-1 (individual partners') TINs because it believes "very few" schedules have incorrect numbers. IRS personnel will sample paper and electronic returns during processing year 2002 to determine the extent of the problem.
3. The IRS will not implement math verification of data from the Form 1065 (or the Schedule K of the Form 1065) to determine if they agree with the sum of corresponding figures reported on the individual Schedules K-1. Instead, it will accept returns electronically when amounts do not match. In processing year 2002, the IRS will conduct a review to determine the extent of the problem; it will probably not reject returns with this problem, but may notify partners in subsequent processing years. The IRS cited Publicly Traded Partnerships as an example where the Schedules K-1 would not be in agreement with the partnership return information, and stated non-Publicly Traded Partnerships *may* also have mismatches in amounts due to a variety of valid reasons.

The IRS stated it will treat electronic and paper returns the same in terms of validation and to do otherwise would impose an additional burden on filers of the electronic returns, which in turn could discourage the voluntary electronic filing of Form 1065.

Office of Audit Comments:

1. We believe a valid partnership TIN should be required before the IRS accepts a partnership return for processing. This is a current requirement for filing electronic individual returns and one which should also be applied to business returns. In addition, it is not efficient to accept a return that cannot be processed by the IRS without spending the IRS' resources to correct something that the taxpayer can more easily correct.
2. We agree with IRS management that returns should not be rejected as a matter of course, due to mismatched individual partners' TINs on Schedules K-1. We made reference to this in our report. However, we do believe the validity of the individual partners' TINs on Schedules K-1 should be monitored and feedback

provided to the partnerships as soon as possible. Penalties should be considered for excessive invalid numbers. The IRS data from last processing year indicated that over 34 percent¹ of the partner TINs were invalid, not “very few” as the IRS’ response indicates. While ETA management’s goal of processing 80 percent of all returns electronically is commendable, the IRS must consider whether it is willing to achieve that goal at the expense of other IRS programs. In this particular instance, returns processed electronically are of no benefit to the IRS’ compliance programs if the TINs are invalid.

3. The IRS should give further consideration to a control comparing Form 1065 information against the individual Schedules K-1, and reassess whether accepting returns that do not match is sound policy. Further, we did, in fact, consider the Publicly Traded Partnership issue in our report, and mentioned that programming could easily eliminate these specific returns from this type of control. We discussed this issue with personnel from a major public accounting firm. They raised the issue of Publicly Traded Partnerships but could think of no reasons for non-Publicly Traded Partnership returns to have mismatches in amounts shown on the returns and Schedules K-1. In its response, the IRS states that non-Publicly Traded Partnerships “may” have mismatches for valid reasons, but gives no specific examples. Assuming this is true, the IRS could establish tolerances to eliminate unnecessary scrutiny for small mismatches, or other programming controls could be used, such as marking these returns for later review.

With regards to treating paper and electronic returns the same, the IRS has an established precedent for treating them differently. The IRS currently requires individual returns to pass up-front math and TIN validity checks. The IRS also has a control which will reject an electronically filed U.S. Individual Income Tax Return (Form 1040) if a Social Security Number for a dependent has been used on another person's Form 1040, whether or not it was correctly input by the first preparer or whether it properly belongs on the second return. This forces some valid electronic returns to be rejected, and the taxpayers must then file and claim the dependents on paper returns.

In summary, we recognize the need to balance the goals of increasing electronic filing with those directed at ensuring the compliance of partners reporting partnership income. However, we also recognize the significant results that the IRS has promised from its Schedule K-1 matching program and the many concerns that the IRS Advisory Council and tax practitioners have regarding the potential for errors and invalid notices resulting from Schedule K-1 information matching. Further, the IRS’ Partnership Research Strategy pointed out the IRS’ need to link partnership returns to the returns of their

¹ This figure represents the percentage of Schedules K-1 that were dropped during last year's underreporter processing computer runs because of invalid TINs.

partners, by capturing accurate individual partners' TINs. We believe the IRS should consider these issues in responding to our recommendation.

While we consider this matter to be worthy of reconsideration by the IRS, we do not intend to elevate it as a significant management decision to which we disagree. Consequently, no further action on your part is required.

Copies of this memorandum are being sent to the IRS managers who received a copy of the final report. In addition, this memorandum will be made available to the public on the Treasury Inspector General for Tax Administration internet site along with the final report and the IRS' response. Please contact me at (202) 622-6510 if you have questions, or Gordon C. Milbourn III, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-3837.

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